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Revenue Effect of "Commerce-2"

Revenues Raised under Revised Tobacco Bill Remain Substantial

Monday's revised version of S. 1415, the tobacco bill (what we refer to as "Commerce-2"), contains many significant changes from the bill as reported, and the fiscal changes are some of the most significant.

This paper limits itself to the revenue effect of Commerce-2. [A separate paper looks at the spending; and for a look at the many other significant changes in Commerce-2, see RPC's Legislative Notice No. 67(a), "Highlights of the McCain Modification ('Commerce-2') issued May 21.] Commerce-2 reduces the number of trust funds from six to a single one and is now on-budget. The trust fund, which remains the bill's primary mechanism for the spending and receiving transactions, now contains different accounts to handle the spending provisions stipulated in the bill. Notable is the fact that the projected amount of revenue flowing into the trust fund is substantially lower than what was estimated previously under "Commerce-1" (the bill as reported). (See, also on p. 2, a discussion of other key revenue changes in the bill.)

The Estimated Revenue Totals Under Commerce-2

This analysis provides an overview of the estimated revenue totals [see attached tables]. Based on estimates of annual industry payments and assuming some (but not the maximum) look-back penalties, RPC concludes that Commerce-2 would raise net federal revenues:

- **\$64.8 billion over five years (JCT estimates),**
- **\$132 billion over nine years (JCT), and**
- **\$514.2 billion over 25 years (RPC).**

In addition to our own work, this paper has made use of analyses from various entities, including: Joint Committee on Taxation (JCT), Congressional Budget Office, Senate Budget Committee, Senate Finance Committee, and the Senate Commerce Committee. This new figure is smaller than earlier estimates made by both OMB (which had estimated revenues of \$755.9 billion over 25 years without including any penalty payments) and by RPC (which in a May 8th paper estimated revenues between \$755.3 billion and \$868.9 billion over 25 years — the range reflecting no

penalty versus the maximum penalty permissible). The main reason for this difference is that Commerce-2 explicitly states that Treasury will estimate and credit *only "net revenues"* to the trust fund. These net numbers are reflected in our new estimates. However, even though the JCT estimates lower net revenues to the federal government, the tobacco consumer will pay the absolute amount (see p. 5 for a per pack discussion).

Key Revenue Changes to Commerce-2

As in Commerce-1, the trust fund created is the entity that receives payments from tobacco producers and makes the disbursements to the various spending programs created by the legislation. Revenues will come from payments made by the participating tobacco companies, fines and penalties in this title, and "look-back" penalties for failure to meet certain underage smoking targets (contained in Title II of the bill). Commerce-2 now explicitly links spending to revenues and makes more spending subject to appropriations (with the exception, most notably, that payments to the states and aid to farmers remain direct spending). The following are other **prominent revisions to the revenue provisions of S. 1415:**

- **Section 401** establishes a single **"National Tobacco Trust Fund" (NTTF)** rather than the six previously created; it funds NTTF with **"net revenues"** rather than the gross amount previously specified. NTTF is **scored as an on-budget entity** for budget purposes rather than off-budget as done previously.
- **Section 402** annual payments provision is treated as before with the exception that the **year-four annual payment is increased** by \$400 million, from \$21 billion to \$21.4 billion.
- **Section 403** now provides that the **base volume for purposes of adjusting the annual payments to reflect changes in volume is 80 percent** of the number of cigarettes sold in 1997.
- **Section 204** increases the **maximum look-back penalty from \$3.85 billion to \$4.4 billion**. Inflation adjustments remain the same. In addition to the increase in the industry-wide penalty for failure to reduce youth smoking, an individual company may also be assessed a penalty if it is deemed to have had a disproportionate share in the reduction failure.

Revenue Effects: "Absolute" versus "Net," and Other Economic Factors

A comparison of "Commerce-1" and Commerce-2 would seem to present a conundrum: Commerce-2 potentially could *raise more revenue* than Commerce-1 (\$885.55 billion, up from \$868.9 billion over 25 years, assuming the maximum annual payments and look-back penalties were paid: see tables); however, *less revenue will be credited to the trust fund* (\$514.2 billion over 25 years, see Table II). Why does this occur? The main reason is the difference between "absolute" and "net" revenues.

- Section 401 of Commerce-2 states: "There shall be credited to the trust fund the *net revenues* resulting from the following amounts: (1) amounts paid under Section 402; (2) amounts equal

to the fines or penalties paid under Section 402, 403, or 405, including interest thereon; (3) amounts equal to penalties paid under Section 202 [*sic*, actual section is 204], including interest thereon. . . . The term 'net revenues' means *the amount estimated by the Secretary of the Treasury*" [emphasis added].

- Commerce-1 did not make this crucial distinction between the total amount of revenue raised from the tobacco industry and the total additional money that would flow to the Treasury — the difference between absolute and net revenues, but JCT did. Why?
- Because JCT (as they explain in a May 15 letter to Republican Whip Don Nickles) sees the effect of Commerce-2's industry payments as *"the same as an excise tax increase."* Any time JCT or any estimator calculates the effect of an excise tax, the result will be "a general reduction in Federal taxable income in the economy which in turn lowers income and payroll tax receipts." In tax analysis parlance, this is known as the "income tax offset" effect. [For a detailed look at this effect, see RPC paper, "Riding the Paper Tiger," Oct. 6, 1997.] The difference between the amounts is 25 percent.
- JCT also estimates that revenue will be reduced because of less federal excise taxes, that is, as demand for tobacco drops due to price increases, the existing federal excise taxes will bring in less revenues.
- Further, JCT in its estimating model takes into account the dynamics between price and demand and the volume adjustment provisions in Commerce-2 — something neither OMB nor RPC did in their initial estimates. This results in reduced overall industry payments as well.
- JCT took into account two factors it says will *increase the overall net trust fund revenues*: (1) Some states can opt out of receiving funds from the trust fund — which has an indirect but positive effect on overall receipts; and (2) the look-back penalties have been increased from a maximum total of \$3.85 billion per year in the Committee reported bill to \$4.4 billion per year in Commerce-2 (which also resulted in our higher absolute payment level in the attached tables).

[Note that JCT in its estimate noted several inconsistencies in the legislative language, which if not corrected, could result in different payment levels from differing interpretations of the language].

The Net Revenue Totals: Payments to the Trust Fund

The attached Table 1 shows both the estimates of the payments to the trust fund and a comparison of the differences with what we call "absolute" totals. (Table 2 shows how the maximum potential payments were calculated: we assume maximum annual payments and maximum look-back penalties, but zero pass-through penalties and zero nonpayment penalties — not because we don't assume they will be assessed, but because they are difficult to estimate).

The elements of Table 1 are explained below:

- **Column 1: Year.** Commerce-2 defines years as calendar years, while JCT estimates on fiscal years. As a result there is some transference of payments in translating between the two.
- **Column 2: Absolute Annual Payments.** These are the highest annual payments that the industry could make — without taking into account the volume or net tax adjustments.
- **Column 3: JCT Net Annual Payment.** These are JCT's estimates of the annual payments to the Trust Fund, through 2007 (which is as far as JCT would estimate).
- **Column 4: JCT Annual Payment Reduction Percentage.** This is the percentage by which JCT reduced the absolute annual payment level (column 2) to obtain the net payment amount (column 3).
- **Column 5: Net Annual Payment at JCT 2007 reduction rate.** In order for RPC to arrive at 25-year figures, we extrapolated the out-years by applying JCT's reduction rate in 2007 (58 percent) to the absolute annual payment levels (column 2). This gives us numbers for the remaining 16 years.
- **Column 6: Absolute Look-Back Penalty.** These are the highest penalty payments that the industry could make — they do not take into account volume or "net" reductions. [Note, we don't attempt to calculate the other allowable penalties in the bill.]
- **Column 7: JCT Look-Back Penalty.** These are JCT's estimates of the look-back penalty payments to the Trust Fund through 2007.
- **Column 8: JCT Reduction Percentage.** This is the annual percentages by which JCT reduced the absolute annual payment level (column 6) to obtain the net payment amount (column 7).
- **Column 9: Net Penalty Payment at JCT 2007 reduction rate.** In order for RPC to arrive at 25-year figures, we extrapolated the out-years by applying JCT's reduction rate in the year 2007 (62 percent) to the penalty payment levels (column 6) for the remaining 16 years.
- **Column 10: Absolute Totals.** This is the maximum industry assessment when the maximum annual payment is added to the maximum look-back penalties (see Table 2 for a detailed description).
- **Column 11: Net totals.** This is RPC's estimated payment to the trust fund from the annual payment and look-back provisions, using JCT's assumptions for the first 9 years, and extrapolating from them for the remaining 16 years.

Price Per Pack and Impact on Taxpayers

According to JCT, the price per pack of cigarettes (calculated based on the total impact of Commerce-2 on the cost of cigarettes) over the next 10 years would be the following:

1998:	\$1.98/pack (current law)
1999:	\$2.88/pack
2000:	\$3.24/pack
2001:	\$3.41/pack
2002:	\$3.66/pack
2003:	\$3.83/pack
2004:	\$4.06/pack
2005:	\$4.12/pack
2006:	\$4.78/pack
2007:	\$4.84/pack

In addition, JCT also estimated how the price increases would affect different income classes. Statistics show that excise taxes are regressive and disproportionately affect those in the lower income brackets. JCT distribution tables found that in 2003, a taxpayer making less than \$10,000 per year would pay 35.1 percent more in federal taxes; a taxpayer making between \$10,000 and \$20,000 would pay 9.6% more; and a taxpayer earning between \$20,000 and \$30,000 would pay 4.2% more. Overall, taxpayers earning less than \$75,000 a year, would pay 54.5 percent more in taxes.

The Volume Adjuster: The Unknown Variable

Section 403(2) of Commerce-2 states, "Beginning with calendar year 2002, the applicable base amount (as adjusted for inflation under paragraph (1)) shall be adjusted for changes in volume of domestic sales by multiplying the applicable base amount by the ratio of the actual volume for the calendar year to the base volume. For purposes of this paragraph, the term "base volume" means 80 percent of the number of taxable domestic removals and taxed imports of cigarettes in calendar year 1997." This volume adjuster is an essential component in determining the annual industry payments. Depending on how consumption levels change, this could increase or decrease industry payments.

However, making the required reductions sufficient to receive a downward adjustment in payments will be difficult for the industry. U.S. consumption in 1997 was 480 billion cigarettes — this was the lowest consumption level in a decade, having fallen from 563 billion in 1988, 500 billion in 1992, and 485 billion over each of the next four years. The base amount stipulated in Commerce-2 then is 384 billion cigarettes — 80 percent of that comparatively low 1997 consumption number.

Further making it difficult for industry to reduce consumption is the fact that the U.S. population is increasing. Current U.S. population is 270 million people. By 2023, the last year projected under Commerce-2, U.S. population is to be 330 million — an increase of 22 percent. So, while this bill has no effect on population growth, it requires cigarette consumption to be reduced —

by 20 percent from 1997 levels. What this means is that reduced smoking by the current population of smokers is not sufficient to meet the volume-adjustment targets. Instead, there must be an absolute reduction in smoking.

Of course, this has large implications for industry payments and therefore federal revenue. JCT's preliminary estimate is that volume adjustments *would be* met and that the annual payments then would be decreased substantially. Under JCT's assumptions, gross industry payments would fall \$3.6 billion in 2002 — the first year the volume adjuster would be in effect — and by \$6.6 billion in 2007 (JCT's last estimated year). If JCT's estimates are not realized federal revenue could be much larger than currently projected.

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Table 1

Tobacco Bill: Net versus Absolute Revenue Totals into the National Tobacco Settlement Trust Fund

(IN BILLIONS OF DOLLARS)

1 Year	2 Absolute Annual Payment*	3 JCT Net Annual Payment	4 JCT Annual Payment Reduction %	5 Net Annual Payment at JCT 2007 Reduction Rate	6 Absolute Look-back Penalty (maximum amts.)	7 JCT Look-back Penalty	8 JCT Penalty Payment Reduction %	9 Net Penalty Payment at JCT Reduction 2007 Rate	10 Absolute Totals	11 Net Totals
1999	24.40	15.40	0.63	15.40	NA	NA	NA	NA	24.40	15.4
2000	15.40	11.00	0.71	11.00	NA	NA	NA	NA	15.40	11
2001	17.70	12.50	0.71	12.50	NA	NA	NA	NA	17.70	12.5
2002	21.40	12.70	0.59	12.70	4.40	NA	NA	NA	25.80	12.7
2003	23.60	13.20	0.56	13.20	4.52	NA	NA	NA	28.12	13.2
2004	24.31	13.80	0.57	13.80	4.64	1.00	0.22	NA	28.95	14.8
2005	25.04	14.30	0.57	14.30	4.77	0.60	0.13	NA	29.80	14.9
2006	25.79	14.80	0.57	14.80	4.89	4.00	0.82	NA	30.68	18.8
2007	26.56	15.40	0.58	15.40	5.03	3.10	0.62	NA	31.59	18.5
2008	27.36	NA	0.58	15.862	5.16	NA	0.62	3.18	32.52	19.05
2009	28.18	NA	0.58	16.338	5.30	NA	0.62	3.27	33.48	19.61
2010	29.03	NA	0.58	16.828	5.45	NA	0.62	3.36	34.47	20.19
2011	29.90	NA	0.58	17.333	5.59	NA	0.62	3.45	35.49	20.78
2012	30.79	NA	0.58	17.853	5.74	NA	0.62	3.54	36.54	21.39
2013	31.72	NA	0.58	18.388	5.90	NA	0.62	3.64	37.61	22.03
2014	32.67	NA	0.58	18.940	6.06	NA	0.62	3.74	38.73	22.68
2015	33.65	NA	0.58	19.508	6.22	NA	0.62	3.84	39.87	23.34
2016	34.66	NA	0.58	20.094	6.39	NA	0.62	3.94	41.05	24.03
2017	35.70	NA	0.58	20.698	6.56	NA	0.62	4.05	42.26	24.74
2018	36.77	NA	0.58	21.317	6.74	NA	0.62	4.16	43.51	25.47
2019	37.87	NA	0.58	21.957	6.92	NA	0.62	4.27	44.79	26.22
2020	39.01	NA	0.58	22.615	7.11	NA	0.62	4.38	46.11	27.00
2021	40.18	NA	0.58	23.294	7.30	NA	0.62	4.50	47.48	27.80
2022	41.38	NA	0.58	23.993	7.50	NA	0.62	4.62	48.88	28.62
2023	42.62	NA	0.58	24.712	7.70	NA	0.62	4.75	50.32	29.46
5-YEAR	102.50	64.80	0.63	64.800	8.919	NA	NA	NA	111.42	64.80
9-YEAR	204.20	123.10	0.60	123.100	28.247	8.700	NA	NA	232.44	131.80
10-YEAR	231.55	NA		138.962	33.41	NA	NA	3.18	264.96	150.85
25-YEAR	755.67	NA		442.828	129.88	NA	0.62	80.10	885.55	514.20

Spreadsheet uses JCT figures where applicable: NA = Not Applicable.

Spreadsheet generates net totals after 2007 by using the percentage reduction from the Absolute Totals and JCT Net payments in 2007: 58% for the annual payments and 62% for the penalty payments.

* 1999 annual payment includes one-time \$10 billion industry payment.

** The legislation stipulates calendar years for payments, while JCT uses fiscal years: The conversion is reflected in JCT's estimates and is captured in the spreadsheet's extrapolation.

Table 2

Tobacco Bill (S. 1415) Absolute Revenue Streams into the National Tobacco Settlement Trust Fund

(in billions of dollars)

Year	One-time Payment	Annual Payment	Look-back Penalties	Pass-through Penalties 110%-125% of shortfall	Enforcement: Nonpayment Penalty: \$100,000/day after 60 days	Inflation adjuster for Annual Payment	Inflation adjuster for Look-back Penalty	GRAND TOTALS
1999	10	14.40				1.03	1.025	24.40
2000	NA	15.40		?	?	1.03	1.027	15.40
2001	NA	17.70		?	?	1.03	1.027	17.70
2002	NA	21.40	4.40	?	?	1.03	1.028	25.80
2003	NA	23.60	4.52	?	?	1.03	1.027	28.12
2004	NA	24.31	4.64	?	?	1.03	1.027	28.95
2005	NA	25.04	4.77	?	?	1.03	1.027	29.80
2006	NA	25.79	4.89	?	?	1.03	1.027	30.68
2007	NA	26.56	5.03	?	?	1.03	1.027	31.59
2008	NA	27.36	5.16	?	?	1.03	1.027	32.52
2009	NA	28.18	5.30	?	?	1.03	1.027	33.48
2010	NA	29.03	5.45	?	?	1.03	1.027	34.47
2011	NA	29.90	5.59	?	?	1.03	1.027	35.49
2012	NA	30.79	5.74	?	?	1.03	1.027	36.54
2013	NA	31.72	5.90	?	?	1.03	1.027	37.61
2014	NA	32.67	6.06	?	?	1.03	1.027	38.73
2015	NA	33.65	6.22	?	?	1.03	1.027	39.87
2016	NA	34.66	6.39	?	?	1.03	1.027	41.05
2017	NA	35.70	6.56	?	?	1.03	1.027	42.26
2018	NA	36.77	6.74	?	?	1.03	1.027	43.51
2019	NA	37.87	6.92	?	?	1.03	1.027	44.79
2020	NA	39.01	7.11	?	?	1.03	1.027	46.11
2021	NA	40.18	7.30	?	?	1.03	1.027	47.48
2022	NA	41.38	7.50	?	?	1.03	1.027	48.88
2023	NA	42.62	7.70	?	?	1.03	1.027	50.32
6-YEAR	10	92.50	8.92	?	?	?	?	111.42
10-YEAR	10	221.55	33.41	?	?	?	?	264.96
25-YEAR	10	745.67	129.88	?	?	?	?	885.55

Annual Payments assume a constant volume after the 6th year and are not adjusted for changes (which could either decrease or increase the annual payments) as stipulated in Sec. 403(2) of Commerce-2.